64

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IN THE SUPREME COURT OF THE UNITED STATES

MICHAEL J. KNIGHT, TRUSTEE OF THE WILLIAM L. RUDKIN TESTAMENTARY TRUST,

Petitioner,

v.

COMMISSIONER OF INTERNAL REVENUE,

Respondent.

On Writ of Certiorari to the United States Court of Appeals for the Second Circuit

BRIEF OF AMERICAN BANKERS ASSOCIATION, CALIFORNIA BANKERS ASSOCIATION, FLORIDA BANKERS ASSOCIATION, ILLINOIS BANKERS ASSOCIATION, KANSAS BANKERS ASSOCIATION, MASSACHUSETTS BANKERS ASSOCIATION, MISSOURI BANKERS ASSOCIATION, NEW YORK BANKERS ASSOCIATION, NORTH DAKOTA BANKERS ASSOCIATION, OHIO BANKERS ASSOCIATION, PENNSYLVANIA BANKERS ASSOCATION, AND THE TEXAS BANKERS ASSOCIATION AS *AMICI CURIAE* IN SUPPORT OF PETITIONER

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TABLE OF CONTENTS

TABLE OF AUTHORITIES.....ii

INTEREST OF AMICI CURIAE.....1

SUMMARY OF THE ARGUMENT.....3

ARGUMENT.....4

CONCLUSION.....12

TABLE OF AUTHORITIES

Cases

Chevron U.S.A. Inc. v. NRDC, 467 U.S. 837 (1984).....4

Mellon Bank, N.A. v. United States, 265 F. 3d 1275 (Fed. Cir. 2001).....5

O'Neill v. Commissioner, 994 F. 2d 302 (6th Cir. 1993) 5, 6, 7

Scott v. United States, 328 F. 3d 132 (4th Cir. 2003).....5

William L. Rudkin Testamentary Trust v. Commisioner of Internal Revenue, 467 F.3d 149 (2nd Cir. 2006).....5

Statutes

20 Pa. Cons. Sta. Ann. §§ 7201 – 7214 (West, Westlaw through 2006-189).....8

26 U.S.C. § 67(e).....3, 4

Alaska Stat. §§ 13.36.225 – 13.36.290 (West, Westlaw through 2006 Sess.).....7

Ariz. Rev. Stat. Ann. §§ 14-7601 – 14-7611 (West, Westlaw through June 20, 2007).....7

Ark. Code Ann. §§ 24-2-610 – 24-2-619 (West, Westlaw through 2006 Sess.).....7

Cal. Prob. Code §§ 16045 – 16054 (West, Westlaw through 2007 Sess.).....7

Colo. Rev. Stat. Ann. §§ 15-1.1-101 – 15-1.1-115 (West, Westlaw through July 1, 2007 Sess.).....7

D.C. Code Ann. §§ 19-1309.01 – 19-1309.09 (West, Westlaw through June 11, 2007) 7

Fla. Stat. Ann. §§ 518.11 (West, Westlaw through June 8, 2007) 7

Haw. Rev. Stat. §§ 554C-1 – 554C-12 (West, Westlaw through 2006 Sess.) 7

Idaho Code §§ 68-501 – 68-514 (West, Westlaw through 2007 First Sess.) 7

Ill. Ann. Stat. ch. 760, para. 5/5, 5/5.1 (West, Westlaw through 2007 Sess.) 7

Ind. Code Ann. §§ 30-4-3.5-1 – 30-4-3.5-13 (West, Westlaw through 2007 First Sess.) 7

Iowa Code Ann. §§ 633.4301 – 633.4309 (West, Westlaw through 2007 First Sess.) 7

Kan. Stat. Ann. §§ 58-24a01 – 58-24a19 (West, Westlaw through 2006 Sess.) 7

Mass. Gen. L. A. 203C, §§ 1 – 11 (West, Westlaw through 2007 First Sess.) 7

Md. Code Ann., Est. & Trusts §§ 14-405(c), 15-114(b) West, Westlaw through July 1, 2007 2005 Sess.) 7

Me. Rev. Stat. Ann. tit. 18-B §§ 901 – 908 (West, Westlaw through 2007 First Sess.) 7

Mich. Comp. Laws §§ 700.1501 – 700.1512 (West, Westlaw through 2007 Sess.) 8

Minn. Stat. Ann. §§ 501B.151, 501B.152 (West, Westlaw through May 22, 2007 Sess.) 8

Mo. Ann. Stat. §§ 469.900 – 469.913 (West, Westlaw through July 13, 2007 Sess.) 8

Mont. Code Ann. § 72-34-601 – 72-34-610 (West, Westlaw through 2005 Sess.) 8

N.C. Gen. Stat. Ann. §§36C-9-901 – 36C-9-907 (West, Westlaw through 2007 Sess.) 8

N.D. Cent. Code §§ 59-02-08.1 – 59-02-08.11 (West, Westlaw through 2005 Sess.) 8

N.H. Rev. Stat. Ann. §§ 564-B:9-901 – 564-B:9-906 (West, Westlaw through July 30, 2007) 8

N.J. Stat. Ann. §§ 3B:20-11.1 – 3B:20-11.12 (West, Westlaw through 2007 Sess.) 8

N.M. Stat. Ann. §§ 45-7-601 – 45-7-612 (West, Westlaw through June 28, 2007 Sess.) 8

Neb. Rev. Stat. §§ 30-3883 – 30-3889 (West, Westlaw through 2006 Second Sess.) 8

Nev. Rev. Stat. §§ 164.705 – 164.775 (West, Westlaw through 2006 Sess.) 8

Ohio Rev. Code §§ 5809.01 – 5809.08 (West, Westlaw through 2005 Sess.) 8

Okla. Stat. Ann. tit. 60 §§ 175.60 – 175.72 (West, Westlaw through July 31, 2007 Sess.) 8

Or. Rev. Stat. §§ 130.750 – 130.755 (West, Westlaw through 2005 Sess.) 8

R.I. Gen. Laws §§ 18-15-1 – 18-15-13 (West, Westlaw through 2006 Sess.) 8

S.C. Code Ann. § 62-7-933 (West, Westlaw through 2006 Sess.) 8

S.D. Codified Laws Ann. §§ 55-5-6 – 55-5-16 (West, Westlaw through 2007 Sess.) 8

Tenn. Code Ann. §§ 35-14-101 – 35-14-114 (West, Westlaw through 2007 First Sess.) 8

Tex. Prop. Code Ann. §§ 117.001 – 117.012 (West, Westlaw through 2007 Sess.) 8

Utah Code. Ann. §75-7-901 – 75-7-907 (West, Westlaw through 2007 Sess.) 8

Va. Code Ann. §§ 26-45.3 – 26-45-14 (West, Westlaw through 2007 Sess.) 8

Vt. Stat. Ann. tit. 9, §§ 4651 – 4662 (West, Westlaw through 2007 First Sess.) 8

W Va. Code §§ 44-6C-1 – 44-6C-15 (West, Westlaw through 2007 First Sess.) 9

Wash. Rev. Code Ann. §§ 11.100.010 – 11.100.140 (West, Westlaw through 2007 Sess.) 9

Wis. Stat. Ann. § 881.01 (West, Westlaw through 2007 Act 18) 9

Wyo. Stat. Ann. §§ 4-10-901 – 4-10-913 (West, Westlaw through 2007 Sess.) 9

Other Authorities

Section 67 Limitations on Estates or Trusts, 72 Fed. Reg. 41243 (July 27, 2007) 5

UPIA, Section 2(a) 9

UPIA, Section 2(c) 9, 10

UPIA, Section 2, Comment 9, 10, 11

UPIA, Section 3 ..... 10, 11

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United States Court of Appeals for the Second Circuit

BRIEF OF AMERICAN BANKERS ASSOCIATION AND STATE BANKERS ASSOCIATIONS AS *AMICI CURIE*[1] IN SUPPORT OF PETITIONER

The American Bankers Association ("ABA"), the California Bankers Association, Florida Bankers Association, Illinois Bankers Association, Kansas Bankers Association,

[1] Pursuant to Rule 37.6, counsel for the parties has consented in writing (copies of which have been filed with the clerk) to the filing of this brief. Pursuant to Rule 37.6, counsel certifies that no counsel for any party authored this brief in whole or in part, and no person or entity other than the *amici curiae* or its members made a monetary contribution to the preparation or submission of the brief.

Massachusetts Bankers Association, Missouri Bankers Association, New York Bankers Association, North Dakota Bankers Association, Ohio Bankers Association, Pennsylvania Bankers Association, and the Texas Bankers Association submit this brief as *amici curiae* in support of Petitioner, the William L. Rudkin Testamentary Trusts.

INTEREST OF AMICI CURIAE

The ABA is the largest national trade association of the banking industry in the country. It represents banks and holding companies of all sizes in each of the fifty states and the District of Columbia, including community, regional, and money center banks. The ABA also represents savings associations, trust companies, and savings banks. ABA members hold approximately 95% of the U.S. banking industry's domestic assets. ABA frequently appears in litigation, either as a party or *amicus curiae*, in order to protect and promote the interests of the banking industry and its members.

Also appearing as *amici* are eleven state bankers associations ("State Association *Amici*"). The State Association *Amici* represent the interests of their members (which include state and federally chartered banks, as well as savings and loan associations) at the state and local levels. They provide a voice for the industry in their respective state legislatures, and support to their members with research and information, public relations, continuing professional education and educational materials, and business development.

The *amici* have a direct interest in the outcome of this litigation. Many of ABA's and the State Association *Amici's* members serve as trustees and executors, or act as agents for individuals who serve as executors or trustees. The issue

presently before the Court concerns the proper construction and interpretation of Section 67(e) of the *Internal Revenue Code* (the "Tax Code"), 26 U.S.C. § 67(e). This statute addresses the taxation of trusts and estates, specifically the deductibility of investment advisory fees. The outcome of this case will have a direct effect upon the manner in which the *amici's* members engage in (and are taxed on) their trust business.

SUMMARY OF THE ARGUMENT

The ABA and the State Association *Amici* respectfully submit that the decision below was incorrectly decided because the court failed to recognize that, unlike individual investors, trustees have an affirmative legal duty to prudently invest trust assets. While individual investors often seek professional investment advice, they do so out of good sense and not legal obligation. Trustees, on the other hand, manage assets and act on behalf of others which, in turn, bind them to certain legal duties and responsibilities, including a duty to prudently manage the trust that is in their care. This legal duty of prudence is embodied and codified in the Uniform Prudent Investor Act ("UPIA"). Since the completion of the UPIA in 1995, versions of this uniform statute have been adopted by 44 states and the District of Columbia as the standard for trust investment law. It is the existence of this duty that differentiates the individual investor from the trustee; because trustees generally have an affirmative *duty* to handle the investment of trust assets in a prudent fashion, and the fulfillment of that duty may require the retention of expert investment help.

ARGUMENT

At issue in this case is whether investment management fees incurred by trustees in carrying out their duties may be fully deducted against the gross income of a trust estate, or whether the expenses may be deducted only to the extent that they exceed 2 percent of adjusted gross income. Section 67(e) of the Tax Code, 26 U.S.C. § 67(e), generally provides that "miscellaneous itemized deductions for any taxable year" are deducted only to the extent "that the aggregate of such deductions exceeds 2 percent of adjusted gross income" of the estate. However, the text of 26 U.S.C. § 67(e) also creates an exception allowing for deduction of trust expenditures without regard to the two-percent floor where two requirements are satisfied: (1) The costs are paid or incurred in connection with administration of the trust, and (2) the costs would not have been incurred if the property were not held in trust. 26 U.S.C. § 67(e)(1). Otherwise, deductibility is limited to the extent it would be for individual taxpayers.

The Internal Revenue Service ("IRS") takes the position that, because investment advisory fees are commonly incurred by individual investors outside the context of trust administration, the taxpayer could not show that they would not have been incurred if the assets were not held in trust. The Service's position[2] has been the subject of litigation

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[2] It is worth noting that the Commissioner opposed review of this case partly on the grounds that the IRS was intending to issue a notice of proposed rulemaking regarding the deductibility of investment advisor fees. The IRS took the position that once the regulations were issued, the matter would be resolved because the court would be *required* to defer to the agency's interpretation of section 67(e) under *Chevron U.S.A. Inc. v. NRDC*, 467 U.S. 837 (1984). The IRS has subsequently issued a notice of proposed rulemaking (...continued)

(including this case), producing varying outcomes. The Sixth Circuit in *O'Neill v. Commissioner*, 994 F. 2d 302 (6th Cir. 1993), concluded that investment management fees are fully deductible by trusts because they "would not have been incurred if the property had not been held in trust."[3] The Federal Circuit[4] and Fourth Circuit[5] have previously reached the opposite result, each holding that Section 67(e) of the Tax Code does not permit the full deduction of investment management fees because these expenses are commonly incurred outside of the trust context. Finally, in the decision below, the Second Circuit advanced a third construction, holding that the statutory language permits a full deduction "only for those costs that could not have been incurred by an individual property owner."[6] Applying this test, which it described as "more restrictive" than that adopted by the Federal and Fourth Circuits,[7] the Second Circuit held that

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that seeks comment on proposed regulations that address the issue before the court. See *Section 67 Limitations on Estates or Trusts*, 72 Fed. Reg. 41243 (July 27, 2007). The *amici* respectfully submit that, apart from the rather curious timing, the IRS's proposed regulations are irrelevant to the court's consideration of this case. The notice of proposed rulemaking was issued by the IRS well *after* the operative facts of this case occurred, and no final regulations have been issued. Further, the Court need not defer to the IRS's interpretation of the law contained in its final regulation – whenever it is issued and in whatever form it eventually takes – if that interpretation is contrary to the express language of the statute or the regulations are arbitrary and capricious.

[3] *O'Neill*, at 304.

[4] *Mellon Bank, N.A. v. United States*, 265 F. 3d 1275, 1281 (Fed. Cir. 2001).

[5] *Scott v. United States*, 328 F. 3d 132, 140 (4th Cir. 2003).

[6] *William L. Rudkin Testamentary Trust v. Commisioner of Internal Revenue*, 467 F.3d 149, 160 (2nd Cir. 2006).

[7] *Id.*

fees paid by trusts and estates for management and investment of assets are never fully deductible - a conclusion that the *amici* believe is incorrect.

The ABA and the State Association *Amici* respectfully submit that the decision below was incorrectly decided because the court failed to recognize that, unlike individual investors, trustees have an affirmative legal duty to prudently invest trust assets. While individual investors often seek professional investment advice, they do so out of good sense and not legal obligation. Trustees, on the other hand, manage assets and act on behalf of others which, in turn, bind them to certain legal duties and responsibilities.

It is the existence of this legal duty of prudence that differentiates the individual investor from the trustee. Trustees generally have an affirmative *duty* to handle the investment of trust assets in a prudent fashion, and the fulfillment of that duty may require the retention of expert investment help. Unlike trustees, individual investors are

> not *required* to consult advisors and suffer no penalties or potential liability if they act negligently for themselves. Therefore, fiduciaries uniquely occupy a position of trust for others and have an obligation to the beneficiaries to exercise proper skill and care with the assets of the trust.

O'Neill, 994 F.2d at 304. The Sixth Circuit found persuasive the existence of a legal duty to potentially seek out and incur costs for investment advice when it concluded that investment management fees are fully deductible under

Section 67(e) of the Tax Code since they "would not have been incurred if the property had not been held in trust."[8]

This legal duty of prudence has been embodied and codified in the UPIA. Since the completion of the UPIA in 1995, versions of this uniform statute have been adopted by 44 and the District of Columbia as the standard for trust investment law.[9]

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[8] *O'Neill,* at 304.

[9] Alaska Stat. §§ 13.36.225 – 13.36.290 (West, Westlaw through 2006 Sess.); Ariz. Rev. Stat. Ann. §§ 14-7601 – 14-7611 (West, Westlaw through June 20, 2007); Ark. Code Ann. §§ 24-2-610 – 24-2-619 (West, Westlaw through 2006 Sess.); Cal. Prob. Code §§ 16045 – 16054 (West, Westlaw through 2007 Sess.); Colo. Rev. Stat. Ann. §§ 15-1.1-101 – 15-1.1-115 (West, Westlaw through July 1, 2007 Sess.); Conn. Gen. Stat. Sec. 45a-541-45a-541*l* (West, Westlaw through June 6, 2007); D.C. Code Ann. §§ 19-1309.01 – 19-1309.09 (West, Westlaw through June 11, 2007); Fla. Stat. Ann. §§ 518.11 (West, Westlaw through June 8, 2007); Haw. Rev. Stat. §§ 554C-1 – 554C-12 (West, Westlaw through 2006 Sess.); Idaho Code §§ 68-501 – 68-514 (West, Westlaw through 2007 First Sess.); Ill. Ann. Stat. ch. 760, para. 5/5, 5/5.1 (West, Westlaw through 2007 Sess.); Ind. Code Ann. §§ 30-4-3.5-1 – 30-4-3.5-13 (West, Westlaw through 2007 First Sess.); Iowa Code Ann. §§ 633.4301 – 633.4309 (West, Westlaw through 2007 First Sess.); Kan. Stat. Ann. §§ 58-24a01 – 58-24a19 (West, Westlaw through 2006 Sess.); Me. Rev. Stat. Ann. tit. 18-B §§ 901 – 908 (West, Westlaw through 2007 First Sess.); Md. Code Ann., Est. & Trusts §§ 14-405(c), 15-114(b) West, Westlaw through July 1, 2007 2005 Sess.); Mass. Gen. L. A. 203C, §§ 1 – 11 (West, Westlaw through 2007 First Sess.); Mich. Comp. Laws §§ 700.1501 – 700.1512 (West, Westlaw
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The UPIA provides, in part that a trustee "shall invest and manage trust assets as a prudent investor would, by considering the purposes, terms, distribution requirements, and other circumstances of the trust."[10] These "other circumstances" that a trustee must take into consideration when executing this duty as a "prudent investor" include:

- general economic conditions;
- the possible effect of inflation or deflation;
- the expected tax consequences of investment decisions or strategies;
- the role that each investment or course of action plays within the overall trust portfolio, which may include financial assets, interests in closely held enterprises, tangible and intangible personal property, and real property; and
- the expected total return from income and the appreciation of capital.[11]

A prudent trustee must consider a trust portfolio as a whole, with an emphasis on what the commentary to the UPIA refers to as "the main theme of modern investment practice, sensitivity to the risk/return curve."[12] A trustee must also consider the "other resources" of the beneficiaries; the beneficiary's needs for liquidity; regularity of income, preservation or appreciation of capital; and an asset's special

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1 – 44-6C-15 (West, Westlaw through 2007 First Sess.); Wis. Stat. Ann. § 881.01 (West, Westlaw through 2007 Act 18); Wyo. Stat. Ann. §§ 4-10-901 – 4-10-913 (West, Westlaw through 2007 Sess.).

[10] UPIA, Section 2(a).

[11] UPIA, Section 2(c).

[12] UPIA, Section 2, Comment on Risk and return.

relationship or special value, if any, to the purposes of the trust or to one or more of the beneficiaries.[13]

The UPIA's approach to trust management presents a marked change from many older statutes that allowed a trustee to simply rely on lists of "approved" investments. The commentary to the UPIA observes that the "universe of investment products changes incessantly."[14] The UPIA's commentary cites the fact that equities and futures were at one time thought to be too risky as one example of this "incessant" change in acceptable investment products.[15] Both are now used in fiduciary portfolios. On the other hand, long-term bonds, once a model trust investment, may be seen as posing their own risks.[16]

Moreover, the requirements of the UPIA itself can make the trust manager's task of prudently investing and managing trust assets complex. Section 3 of the UPIA requires that a "trustee shall diversify the investments of the trust unless the trustee reasonably determines that, because of special circumstances, the purposes of the trust are better served without diversifying."[17] At the same time, a strategy that minimizes the taxation incident to portfolio turnover is preferred.[18] A trustee is also required to make a reasonable effort to verify facts relevant to the investment and

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[13] UPIA, Section 2(c).

[14] UPIA, Section 2, Comment on abrogating categorical restrictions.

[15] UPIA, Section 2, Comment.

[16] UPIA, Section 2, Comment.

[17] UPIA, Section 3.

[18] UPIA, Section 3, Comment.

management of trust assets.[19] Prudent diversification and proper asset allocation may well include investments in asset classes other than high-quality bonds and large capitalization stocks. Trustees may find it necessary to invest in a far broader array of assets including international stocks, international bonds, small capitalization stocks, real estate, timber, venture capital funds, hedge funds or high-yield bonds. In some (but not necessarily all) instances, a trustee simply may not have the expertise at hand to prudently make these investments, compelling them to embrace an "open architecture" strategy employing one or more third party investment specialists.

Many trustees or fiduciaries would find it daunting – or irresponsible – to take on the complex duty of administering a trust without the help of professional investment assistance. In such cases, the legal duty to act as a "prudent investor" would dictate that a trustee hire one or more investment managers to handle the complexities inherent in modern trust management. Indeed, the drafters of the UPIA anticipated that a prudent trustee will choose to hire an investment manager or seek professional advice in order to ensure the proper management of the assets, and that such a delegation will often benefit the trust beneficiaries.

In sum, the Court should conclude that the Second Circuit decided the case below incorrectly. The existence of a legal duty of prudence differentiates the individual investor from the trustee, and the fulfillment of that duty of prudence may require a trustee to retain expert investment help. The advice received by the trustee (and for which the fees are incurred) is in most cases peculiar to the particular trust in light of the trust's purpose and other factors outlined by the

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[19] UPIA, Section 2, Comment.

UPIA. The Court should ultimately conclude that investment management fees are fully deductible by trusts under Section 67(e) of the Tax Code because they "would not have been incurred if the property had not been held in trust."

CONCLUSION

Based upon the foregoing, the ABA and State Association *Amici* urge the Court to grant the petition for certiorari to resolve the conflict between the circuits and to provide a uniform interpretation of the Tax Code.

Respectfully submitted,

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